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November 12, 2004

Mr. Keith Rake
Deputy Assistant Commissioner
Bureau of the Public Debt
Department of the Treasury
200 3rd Street
Parkersburg, WV 26101

Re: Docket Number BPD-02-04
Comments on Proposed SLGS Regulations
31 CFR Part 344

Dear Mr. Rake:

We understand the purpose of the proposed regulations, which is to end the alleged practice of certain governmental bodies to use the SLGS Program to allow investment at rates that are more favorable than those available in the open market. In essence, the Treasury Department believes that some purchasers of SLGS have been using the SLGS program to obtain a material financial advantage within the arbitrage limits imposed by Section 148 of the Internal Revenue Code of 1986 (the *"Code"*). This advantage is usually based on the embedded options inherent in SLGS subscriptions filed from 1996 through 2004.

Although some investors may, by careful timing, have used the SLGS program to obtain above market returns, we believe that as a whole, though the purchase of below market rate SLGS, including zero yield SLGS, overall SLGS investors have collectively received below market returns. The SLGS program has actually reduced the borrowing cost of the United States of America.

In 1996, the SLGS program was amended in response to a 1986 congressional mandate to make the SLGS program more attractive to potential investors. Congress wanted these changes to discourage the use of investment purchases on the open market for yield limited funds. The use of such open market investments was thought to lead to diversion of arbitrage profits through a process called "yield burning."

The result of the 1996 amendments (and further amendments in 1999 and 2000) was to create a program that was investor friendly. The current program builds in a large degree of flexibility that makes the SLGS program attractive to users. That is the intended result of the 1996 changes.

While we understand the purpose of the proposed restrictions on the SLGS program, we believe that the Proposed Regulations went too far. Many of the routine SLGS purchases, necessary for ensuring compliance with arbitrage and private activity bond regulations will be difficult, uneconomic, or in some cases impossible. Below are several suggestions for relieving these burdensome changes along with the types of transactions affected.

1. Amend the Proposed requirement that bonds be authorized prior to the beginning of a SLGS subscription.

Proposed Regulations Section 344.5(b)(5) requires that the investor identify at the start of its subscription the bond issue the gross proceeds of which will be invested. We have no objection to this identification requirement.[1] Section 344.2(e)(2) effectively requires that the issuer of the identified bonds authorize the bond issue *prior* to the start of the subscription process. Authorization has specific but varying meaning under various state laws. Under state law, such authorization is often required to be made by the governing board of the issuer. Often these board meetings are held in the evening. The tradition of holding board meetings at night is an old one, meant to accommodate both board members and members of the public who may have other jobs.

In many advance refunding bond issues, the exact size of the issue cannot be determined until SLGS or other investments intended for the advance refunding issue are selected. The Bonds often cannot be authorized until the exact principal amount is determined. In the case of SLGS, this means that a subscription for those SLGS must be filed no later than the date of the determination. The following is an example of a typical time line for the sale and authorization of a bond issue.

On the "pricing day" for the proposed bond issue:

1. Underwriting firm pre-sells to investors the to-be-issued tax exempt bonds.

2. Underwriter runs calculations determining the proposed issue's bond yield, the SLGS to be purchased, and anticipated savings for the issuer.

[1] We do believe that it is important to allow a single SLGS subscription for the investment of gross proceeds of multiple bond issues. A suitable SLG Safe modification could make that possible.

3. An accounting firm verifies that the underwriter's calculations are mathematically accurate.

4. Issuer staff, attorneys, financial advisors, and possibly a board member reach agreement with the underwriters on the terms of a bond purchase agreement. Attorneys draft a bond resolution or ordinance, and certain other necessary documents.

All of the above are normally completed by 5:00 local time. Note, however, that the Bonds have not yet been officially authorized by the governing board.

5. At an evening meeting, the Board adopts the Bond Resolution or Ordinance authorizing the Bonds.

6. At any time before completion of Step 5 above, the Issuer or its agent files a SLGS subscription form. Most commonly this is begun during normal business hours and completed before the board meeting because a commercial bank is the agent completing the subscription.

Under the proposed regulations, the SLGS subscription form could not be filed at night after the evening meeting, but could also not be filed prior to the authorizing meeting. The Issuer cannot simply wait until the following business day to file the subscription because the SLGS rate table might then be different requiring a new bond size. Although some bond issues are authorized by "parameters resolutions" under which a single officer may agree to final terms, the ability to do so is often limited by legal or political concerns.

We suggest the following change to the proposed ruling to accommodate this common situation while satisfying the purpose of the requirement for prior authorization of the bond issue.

Proep Reg 344.2(e)(2) should be changed to read:

> *"Upon starting a subscription, the subscriber must certify that either (i) that the issuer has authorized the issuance of the state or local bonds or (ii) that the terms (including the yield) of the state or local bonds have been substantially determined and that the subscribing agent believes that such bonds will be authorized within 60 hours"*

If the United States Treasury Department believes it is necessary, an additional requirement that the Issuer confirm that the bonds have in fact been authorized within such 60 hour time period would be reasonable. We believe that very few subscriptions would under the proposal be begun with respect to bond issues that are not in fact authorized as expected.

We have proposed a 60 hour period in which authorization is expected even though 8 hours would accommodate many such transactions. Some issuers allow bonds to be pre-sold one or two days prior to the authorizing meeting. In fact, although 60 hours will accommodate most bond issues, a longer period would be useful to some issuers. A seven day period would, we believe accommodate nearly all issues and would not open up any opportunity for abuse.

We wish to emphasize that adoption of the proposed regulations without this change might place an issuer in a "catch 22" situation. If, based on SLGS rates in effect on the day of pricing, SLGS are no more expensive than open market securities, the arbitrage tax rules would effectively prohibit the use of anything but SLGS in the escrow. However, because of the timing of subscriptions, SLGS would not be permitted.

2. Proposed Regulations Should not Prohibit A Closing Date Delay.

Current regulations permit a subscription to be amended to delay the date of issue by up to 7 days. This is indeed an embedded option. It is not however an option that to the best of our knowledge is used by anyone to obtain above market yields. It is used when unforeseen difficulties delay the availability of funds for investment. The elimination of this "option" is unnecessary and would cause significant problems when a transaction is unavoidably delayed. The current rule should be retained. Eliminating the seven day rule will create more uncertainty for the Bureau of the Public Debt than the current rule. If the settlement cannot be delayed, the issuer will have no choice but to cancel the subscription. (Or if the Bureau of Public Debt does not allow the cancellation, default on its obligation to purchase the SLGS). An issuer can't purchase SLGS if it has no money for the purchase.

Things do occur which in fact delay closings. Litigation can be filled in connection with a bond issue at the final hour, which requires analysis and new disclosure before the bond issue can close.

3. Proposed Regulations overly restrict the amount that the par amount of small subscriptions that may be changed.

The Proposed Regulations would eliminate the $10,000,000 amount by which SLGS subscription amounts may be amended and would allow only 10% changes. However, for small subscriptions, a straight 10% limit may be insufficient. We would prefer to see a fixed dollar floor on the maximum amount of an amendment be retained; perhaps at a level significantly below the current $10,000,000. For example, we believe that it would be appropriate to allow SLGS subscription to be amended by up to the greater of 10% of the principal amount or $100,000. This would allow a $600,000 subscription amount to be amended down to $500,000. The cost to the U.S. Treasury would be minimal, but it would make the SLGS program easier to use by issuers who sometimes do not know the exact amount available for investment at the time a subscription is begun.

4. Establish a Duration of Yield limitation test.

Two yield test restrictions apply to proceeds of the early liquidation of investments.

a) liquidation proceeds of investments may not be invested in SLGS at a yield above the liquidation yield (Prop Treas. Reg. 344.2(e)(3)(i)); and

b) proceeds of the early redemption of SLGS may not be invested in any investment at a yield above the SLGS liquidation yield.

The two rules are clearly intended to prevent so called escrow restructurings under which lower yielding investments are replaced with higher yielding investments (presumably available only because of pricing inefficiencies). We question whether such rule is necessary at all when the Bureau of the Public Debt will be removing most of the pricing inefficiencies for SLGS. However, if the rules are adopted, at a minimum the rules should be crafted to expire when the liquidated investment would in any case have matured. Assume for example, that gross proceeds are temporarily invested in a United States Treasury Bill maturing two months after purchase. Assume that the issuer wants to reinvest the amount in three year SLGS. If it waits until the maturity date of the T-Bill, it may make the reinvestment at a yield in excess of the two month T-Bill rate. If however, the Issuer liquidates the T-Bill prior to maturity (even one day prior to maturity) the SLGS reinvestment rate would be limited to the liquidation yield on the T-Bill for a full three years. This yield would likely be very low because it would be based on the yield from liquidation date to maturity date of the investment. (Potentially, a 1-day rate). The concern is not alleviated by an intervening investment. If the issuer wants to invest proceeds in SLGS, it will have to check the liquidation yield of any temporary investment, even ones that would have matured earlier if held to maturity. Application of the yield limitation rule in the context does not relate to the replacement of a lower yielding investment with a higher yield investment. The solution to the problem is to limit the application of the rule to replacement investment that are purchased prior to the date on which the original investment would have matured if it had not been redeemed or liquidated early. We propose the following language:

3(i) ...

(A) If the issuer is purchasing a SLGS security with proceeds of the sale or redemption (at the option of the holder) before maturity of any marketable security and such purchase of a SLGS security occurs prior to the scheduled maturity date of the sold or redeemed marketable security then, the yield or such

SLGS security, does not exceed the yield at which such marketable security was sold or redeemed; and

(B) If the issuer is purchasing a SLGS security with proceeds of the redemption before maturity of a Time Deposit Security, and such SLGS security purchase occurs before the scheduled maturity date of the redeemed Time Deposit Security, then, the yield on the SLGS security being purchased does not exceed the yield that was used to determine the amount of redemption proceeds for such redeemed Time Deposit Security.

(ii) Upon submission of a request for redemption before maturity of a Time Deposit Security subscribed for on or after the date of publication of the final rule, the issuer must certify that prior to the scheduled maturity date of the Time Deposit Security being redeemed no amount derived from the redemption, will be invested at a yield that exceeds the yield that is used to determine the amount of redemption proceeds for such Time Deposit Security.

5. Early liquidation of Zero Yield SLGS, Money Market Fund and other investments payable on demand should be treated as redemptions at maturity.

When a zero yield Time Deposit SLGS Security is redeemed early, the redemption proceeds are equal to the par amount of the redeemed SLGS security. Similarly, many market funds and certain bank deposits are payable at par on demand. Although such investment may in theory be redeemed prior to maturity, in practice such redemptions are treated economically at a payment at maturity. We recommend a clarifying insertion into Proposed Treas. Reg.

Section 344.2(e)(3)

(iii) for purposes of (i) or (ii) the redemption at par of a Zero Yield Time Deposit SLGS Security, a money market fund, or any other investment redeemable at the option of the holder thereof at par will be treated as a redemption at maturity of such investment.

6. The .05% reduction in the computation of the SLGS Rate Table should be eliminated.

Currently, and presumably under the proposed regulations, the table of maximum interest rate is intended to be computed as .05% below the corresponding open market yield. There are multiple purposes of the .05% under the current rules. However, to the extent that such .05% is not treated as the cost of what is referred to as a "cost free option," it is essentially an administrative cost.

The full .05% reduction cannot be justified as compensation for the cost of administering the SLGS program, particularly for large purchases. The Internal Revenue Service recognized this when their rules on "qualified administrative costs" were amended late last year. If the Bureau of Public Debt wants to recover administrative expenses from SLGS purchasers, it should charge a separate administrative expense no higher than the amount deemed a reasonable charge under Treas. Reg. 1.148-5. The amount should be equal to at most .20% of the amount invested, but no more than $30,000.

We do note that zero yield Time Deposit SLGS securities are often purchased with proceeds of maturing investments as part of a planned program to keep yield below limits imposed by tax law. It would be disruptive for the Bureau of Public Debt to charge a fee for such SLGS securities, and therefore we recommend that if this suggestion is adopted, the administrative fee be waived for zero yield Time Deposit SLGS Securities.

We also note that adoption of this suggestion would require a simplifying change to appendix B to the regulations.

8. The Final Regulations should clarify the limitations on the source of money invested in SLGS.

Current regulations allow the investment in SLGS securities of any amounts that assist the issuer of tax exempt bonds in complying with the rules related to maintenance of tax exempt status. This rule should be retained and clarified. There are at least three instances under which investment of amounts that are not gross proceeds of an issue may affect the tax exemption of the issue. Under the income tax regulation's 1-issue rule (Treas. Reg. 1.148-6(b)) proceeds of one issue are not also gross proceeds of another issue. However, such amounts may none-the-less be restricted to the bond yield of the issue of which they are not gross proceeds. Under Treas. Reg. 1.141-12 an issuer is required to take a remedial action in the case of unexpected private use of tax exempt bond financed facilities. One such remedial action (and often the only practical remedial action) is the establishment of a defeasance escrow for the tax exempt issue. The defeasance escrow is required by Treas. Reg. 1.141-12 to be invested at a yield that is not materially higher from the yield on the tax exempt issue. Where there is no other reasonable source for funding such a defeasance escrow, taxable bonds must be issued and used to fund the defeasance escrow. Under Treas. Reg. 1.148-6 the amounts in the defeasance escrow are proceeds (and gross proceeds) of the taxable issue. Even though they are not gross proceeds of any tax exempt issue, they must be invested at or below the tax exempt bond yield.

Another situation involving yield restricted amounts that are not at all times gross proceeds of tax exempt issue is the investment of amounts that "transfer" from a tax exempt issue to a taxable issue or vice versa under the so called transferred proceeds rules. Compliance with the rules for tax exemption is often much simpler if a single investment can be used for amounts that may become transferred proceeds of an issue.

We note that under the proposed regulations, the issuer should be able to identify the taxable bond issue and invest these amounts in SLGS securities as gross proceeds of the taxable issue. However, there has been some concern that the Bureau of Public Debt might interpret the rule to apply only to gross proceeds of a tax-exempt issue. If the Final Regulations do retain the limitation that only gross proceeds of an issue be invested in SLGS securities, it is important for the text or preamble to the regulations to clarify that gross proceeds of taxable issues may be invested in SLGS securities.

A third reason for investing non-gross proceeds in SLGS securities is the use of "commingled funds." Under the income tax regulations a commingled fund is a fund that contains substantial amounts of gross proceeds of an issue and substantial other money. Arbitrage regulations allow such amounts to be invested without regard to the source of the investment, with interest earnings allocated to the different sources in an appropriate manner. It is often useful for an issuer to invest the entire commingled fund in SLGS even though only a portion of it is gross proceeds of a given issue. We note that (unlike the two previous examples) this commingled fund problem is not solved by allowing gross proceeds of a taxable issue to be invested in SLGS. The commingled funds may include amounts not gross proceeds of any issue.

Many times commingled funds include gross proceeds of two or more tax exempt issues. Of course in such case, the entire commingled fund could, under the proposed rules, be invested in SLGS. However, as drafted separate SLGS subscriptions might be needed for the proceeds of each issue even though the amounts are being invested without regard to the source of investment. For example often times advance refunding escrow accounts contain both gross proceeds of the advance refunding issue and other money that is gross proceeds of the refunded issue. For simplicity the entire account is yield restricted to the lower (usually refunding bond) yield. The additional complexity could be avoided if the current rule permitting SLGS securities investment for any amounts that assist the issuer in complying with the rules related to tax exemption is maintained. Alternatively, it could be helpful if the final regulations clarified that a single subscription could be filed for gross proceeds of multiple issues, and that only one such issue needed to be identified in the subscription.

We hope that these written comments are useful to you in finalizing the regulations. We can, of course, be reached to answer any questions you may have (e-mail: cholst@chapman.com, telephone (312) 845-3862). The author of these comments also participated in drafting the comments submitted by the National Association of Bond Lawyers. However, we believe that certain comments made in this letter were missing from those comments or needed to be emphasized. We understand that no public hearing has been scheduled with respect to the proposed regulations. Considering the importance of the proposed changes, we would encourage you to hold a public hearing, and should you decide to schedule such a hearing, we would want the opportunity to speak.

Thank you for your consideration.

Sincerely,

CHAPMAN AND CUTLER LLP

By David Cholst
David J. Cholst

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